Attachment B

"Federal Crude Oil Valuation Rulemaking," MMS Congressional Briefings, February 1998.

Federal Crude Oil Valuation Rulemaking

Congressional Briefings
February 1998

Outline

- Background
- Second Supplementary Proposed Rule

Why MMS is Considering Revisions to the Regulations

Proposed rulemaking results from:

- Changes in the domestic crude oil market

  AND

- MMS objectives to:
  - Decrease reliance on posted prices
  - Develop rules that reflect market value
  - Reduce administrative costs of royalty valuation

Proposed Rulemaking

- Proposed rule published 1/24/97
- True arm's-length sales: Gross Proceeds
- Non-arm's-length sales, exchange agreements, crude oil calls, reciprocal purchases: INDEX
  - ANS in California and Alaska
  - NYMEX for the rest of the country

Proposed Rulemaking

- Reopened comment period 9/22/97
- Requested comments on five alternatives
  - Outright sales (tendering)
  - New benchmarks
  - MMS-calculated prices by geographic region
  - Fixed differentials
  - Spot prices
- Comment period closed 11/5/97

Proposed Rulemaking

- In addition to two public hearings held in April 1997, MMS held seven workshops across the country

- MMS received written comments on the five alternatives from 28 entities

Supplementary Proposed Rulemaking

Supplementary proposed rule published 7/3/97 would:

- Eliminate 2-year purchase provision
- Require payors with calls to use NYMEX <u>only</u> when the call is exercised and noncompetitive
- Allow payors with arm's-length exchange agreements to base value on the arm's-length sale after exchange

Supplementary Proposed Rulemaking

- Under the supplementary rule, value would be based on arm's-length gross proceeds <u>unless</u>:
  - Sales contract does not reflect total consideration
  - Value is not reasonable due to misconduct
  - Oil is disposed of under an exchange agreement, except in the case of an arm's-length exchange agreement; then based on the arm's-length sale after the exchange

Supplementary Proposed Rulemaking

- **Under the supplementary rule, value would be based on arm's-length gross proceeds <u>unless</u>:**
  - ***An overall balance is maintained between buyer and seller***
  - ***Non-competitive crude oil call is exercised***

Second Supplementary Proposed Rulemaking

- Published February 6, 1998
- 45-day comment period
- MMS plans several public meetings to receive comment on the supplementary proposed rule
    - Feb. 18 Houston, TX
    - Feb. 25 Washington D.C.
    - March 2 Denver, CO
    - March 11 Bakersfield, CA
    - March 12 Casper, WY

Second Supplementary Proposed Rulemaking

Five Principles:

- **Royalty must be based on the value of production at the lease.**
- **For arm's-length contracts, royalty obligations should be based on gross proceeds.**
- **For other than arm's-length contracts, index prices are the best measure of value for most areas of the country.**

Second Supplementary Proposed Rulemaking

- *The lessee has a duty to market at no cost to the lessor.*
- *Customized regulations for unique producing areas are preferable to a "one size fits all" approach.*

Second Supplementary Proposed Rulemaking

- **Gross proceeds under an arm's-length contract determine value UNLESS:**
  - Contract doesn't reflect total consideration
  - Value not reasonable due to misconduct
  - Oil disposed of under an exchange agreement, except one or more arm's-length exchange agreements; then value based on the arm's-length sale after the exchange(s)
  - Oil disposed of under noncompetitive crude oil call

Second Supplementary Proposed Rulemaking

- Oil NOT sold at arm's length:
  - <u>Rocky Mountain Area - first applicable:</u>
    - MMS-approved tendering program
    - Weighted average of lessee's/affiliate's arm's-length sales and purchases in the field/area
    - NYMEX adjusted for location and quality
    - MMS-established alternative method

Second Supplementary Proposed Rulemaking

Oil NOT sold at arm's length:

- California and Alaska
  - Spot price for ANS, adjusted for location and quality
- Rest of the Country
  - Spot price for the market center nearest the lease, adjusted for location and quality

Second Supplementary Proposed Rulemaking

- **Location and Quality Adjustments**
  - ***From market centers to aggregation points:***
    - *Actual rates or MMS published rates*
  - ***From aggregation points to leases:***
    - *Actual costs of transportation and quality adjustments based on pipeline quality banks*
  - ***MMS will determine allowance from the lease to the aggregation point if actual costs are not available to the lessee***

Second Supplementary Proposed Rulemaking

- Simplified Form MMS-4415 requires:
  - Information only on exchanges involving Federal oil
  - Information only on exchange agreements from aggregation points to market centers
  - Less data elements than earlier form
  - One-third less MMS-identified aggregation points

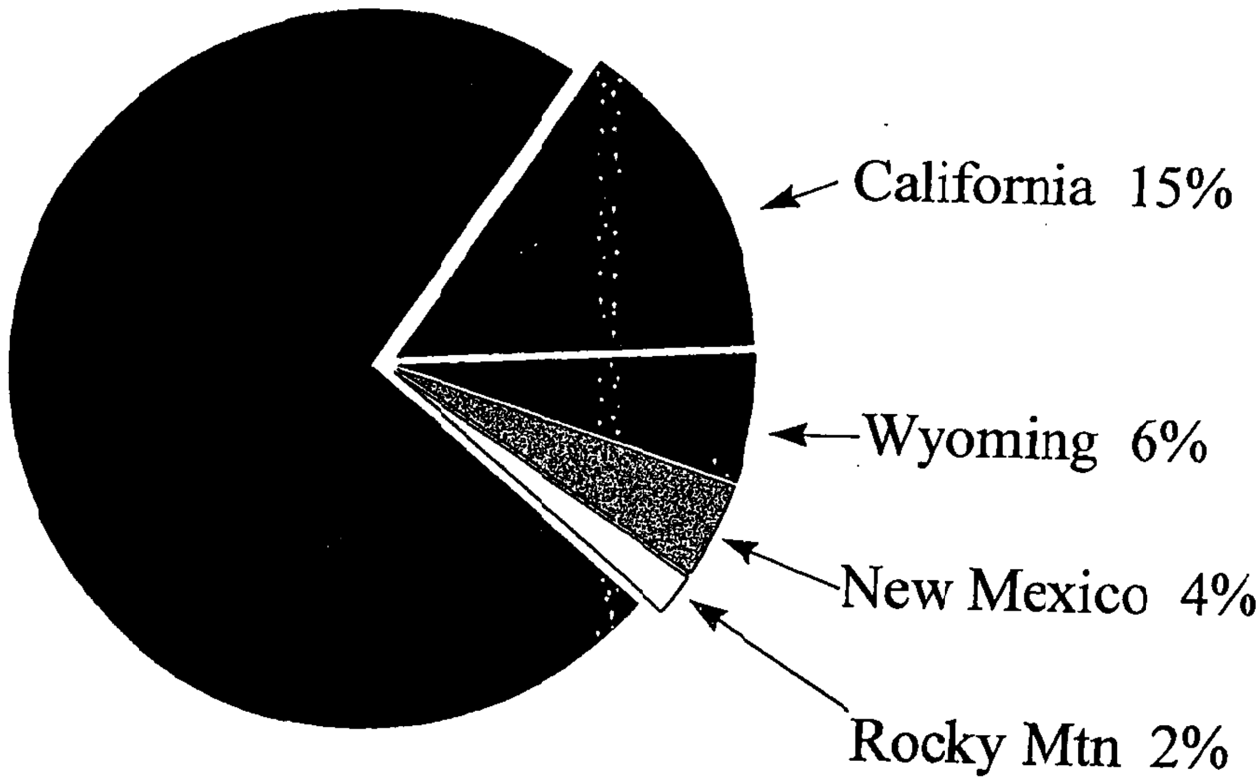
Second Supplementary Proposed Rulemaking

- **Simplified Form MMS-4415 requires:**
  - *Information only on exchanges involving Federal oil*
  - *Information only on exchange agreements from aggregation points to market centers*
  - *Less data elements than earlier form*
  - *One-third less MMS-identified aggregation points*

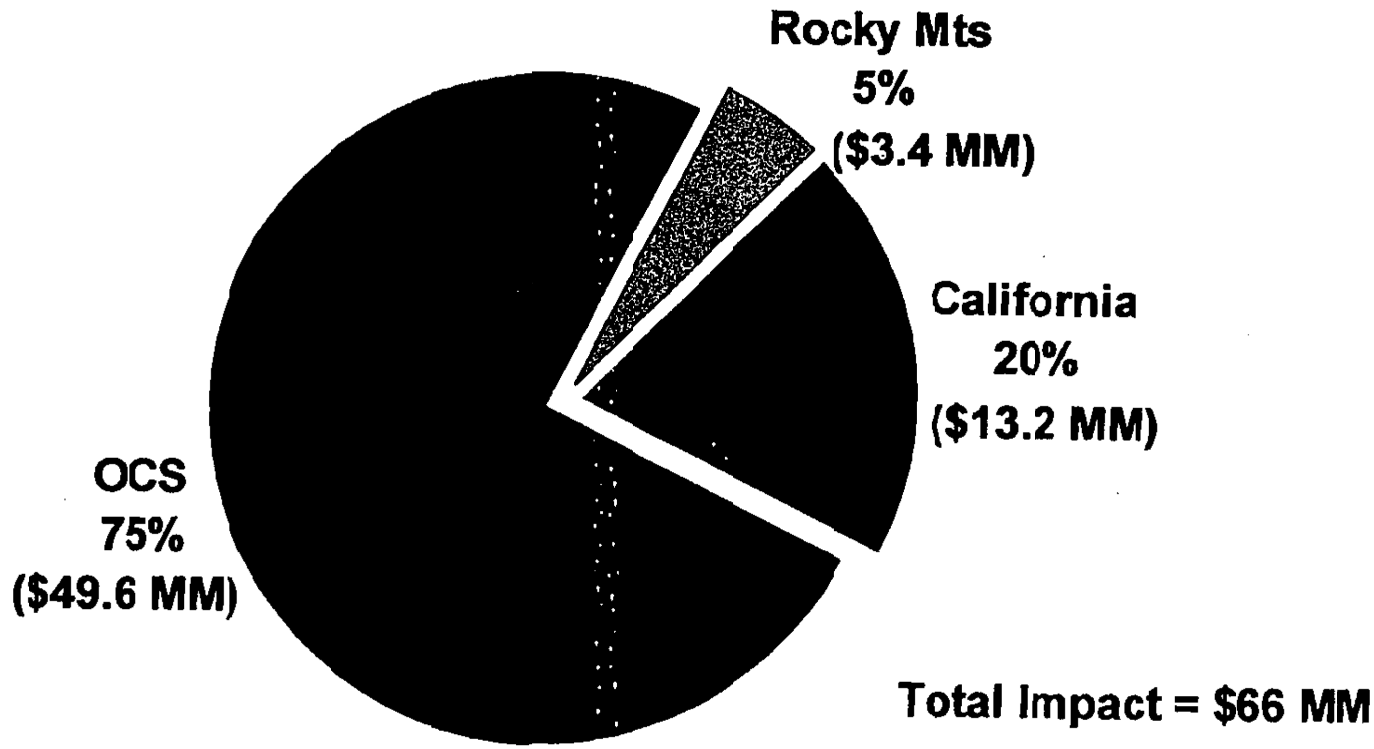
Second Supplementary Proposed Rulemaking

- **Other Features:**
  - ***Timing of index prices coincides production month to delivery month***
  - ***Eliminates proposed changes to valuing oil taken in-kind and sold to eligible refiners***

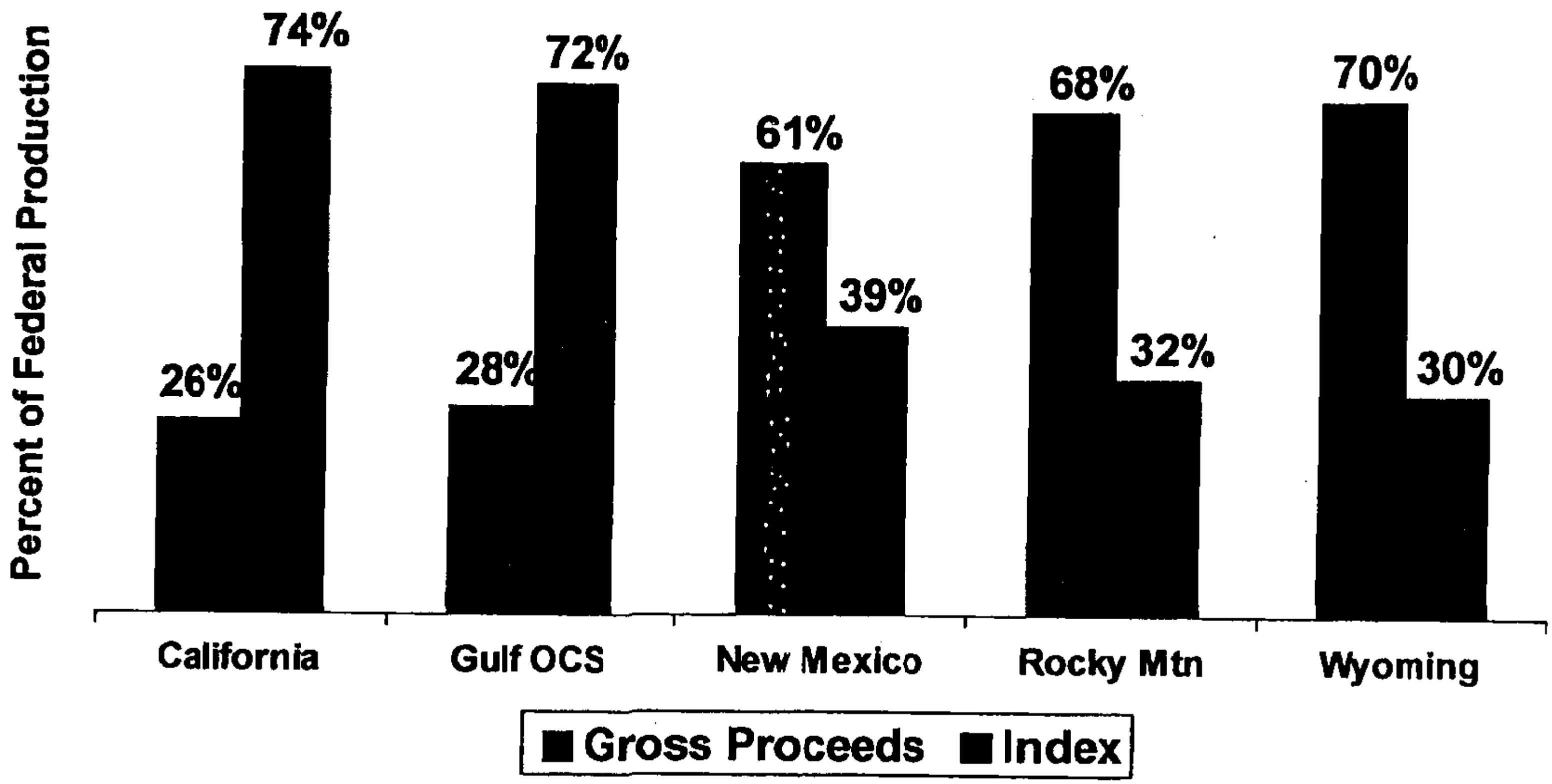
Federal Crude Oil Production by Area



Royalty Impact of Supplementary Rule by Area

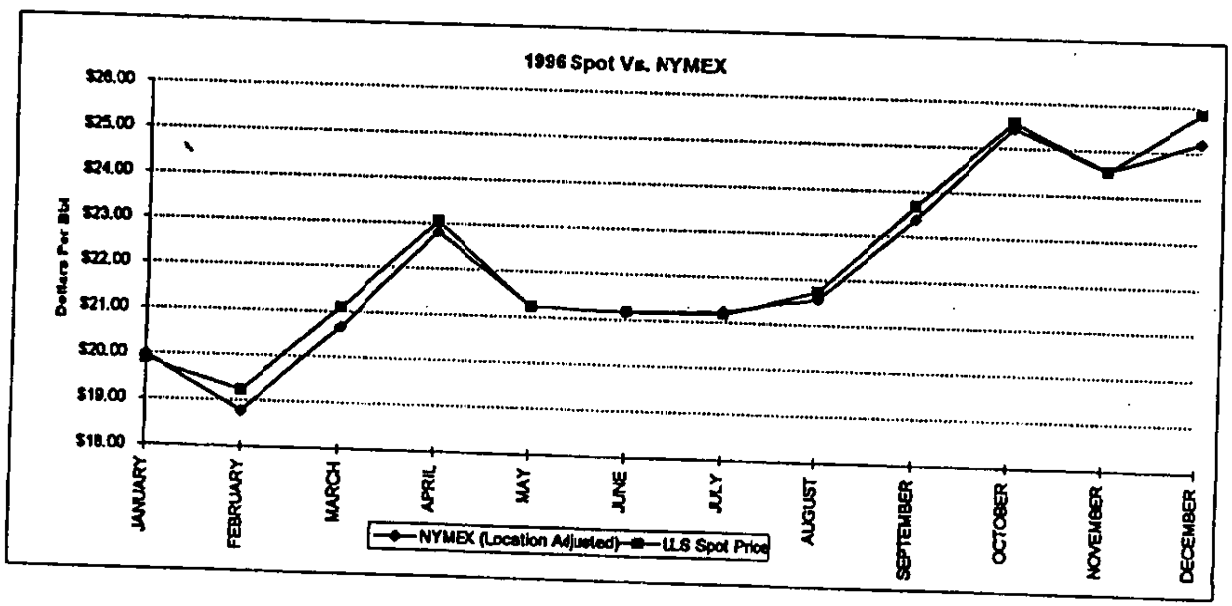


Valuation Method by Area



Average Monthly NYMEX Price (minus St. James differential) vs. St. James Spot Price
(Spot price used is Light Louisiana Sweet)

1996	NYMEX Minus Differential	St. James Ave. Spot Price	Difference
JANUARY	$19.98	$19.88	($0.10)
FEBRUARY	$18.78	$19.23	$0.45
MARCH	$20.66	$21.09	$0.43
APRIL	$22.82	$23.05	$0.23
MAY	$21.23	$21.24	$0.01
JUNE	$21.17	$21.17	$0.00
JULY	$21.25	$21.17	($0.08)
AUGUST	$21.56	$21.73	$0.17
SEPTEMBER	$23.38	$23.68	$0.30
OCTOBER	$25.43	$25.56	$0.13
NOVEMBER	$24.53	$24.53	$0.00
DECEMBER	$25.19	$25.84	$0.65



2/6/98 rule

VALUATION PROCEDURE	CALIFORNIA/ ALASKA	ROCKY MOUNTAIN AREA	REST OF COUNTRY
Oil sold under an arm's-length contract* *** Including sales to affiliates who resell at arm's-length**	Gross proceeds determines value unless: 1) Contract doesn't reflect total consideration 2) Value is not reasonable due to misconduct 3) Oil is disposed of under an exchange agreement, except one or more arm's-length exchange agreements, then value based on the resale after the exchange(s) 4) Oil is disposed of under a non-competitive crude oil call	Same	Same
Oil NOT sold under an arm's-length contract	Value is based on spot price for Alaska North Slope crude, adjusted for location and quality	Value is based on first-applicable of following: 1) MMS-approved tendering program 2) Weighted average of lessee's/affiliate's arm's-length sales or purchases from the field/area 3) NYMEX-based price, adjusted for location and quality 4) MMS-established alternative method	Value is based on spot price for the market center nearest the lease (e.g., St. James, Louisiana, or Midland, Texas) adjusted for location and quality
Location, quality, and transportation adjustments	Actual rates or MMS-published rates from market centers to aggregation points Actual costs of transportation and quality adjustments based on pipeline quality banks, from aggregation points to leases Simplified Form MMS-4415 requires: 1) Information only on exchanges involving Federal oil and only from market centers to aggregation points 2) Less data elements than earlier form 3) One-third less aggregation points	Same	Same

Federal Crude Oil Valuation Proposed Rulemaking --
Comparison of Original Proposed Rule, Supplementary Rule, and Secondary Supplementary Rule

Lessee may use gross proceeds paid under an arm's-length contract UNLESS:

January 24, 1997 Proposed Rule	July 3, 1997 Supplementary Rule	February 6, 1998 Supplementary Rule
The sales contract does not reflect the total consideration,	No change	No change
The value under the contract does not reflect a reasonable value due to misconduct,	No change	No change
Oil is disposed of under an exchange agreement,	Oil is disposed of under an exchange agreement except where the oil you receive in the exchange is then sold arm's length If lessee exchanges arm's-length and resells arm's-length then the lessee may elect index or arm's-length resale after the exchange Use same election (2 years) to value all oil disposed of under arm's-length exchanges where exchanged oil is sold arm's length If lessee transfers oil to an affiliate before exchange, use non-arm's-length valuation methods An overall balance is maintained between the buyer and seller	Same, plus arm's-length resale gross proceeds also apply if multiple exchanges occur and the oil finally received is sold at arm's length If lessee exchanges arm's-length and then resells arm's length, lessee must pay on arm's-length resale gross proceeds (regardless of number of exchanges) Election no longer an option If lessee transfers oil to an affiliate and affiliate engages in arm's-length exchange(s) and subsequently sells the oil received at arm's length, lessee must pay on arm's-length gross proceeds Eliminated (covered under total consideration received)
Oil is subject to a crude oil call,	Exercise of a non-competitive crude oil call	No change
The lessee (or its affiliate) purchased oil in last 2 years.	No restriction on oil purchases	No change

OTHERWISE:

January and July 1997 Proposals	**February 1998 Proposal**
Sales to affiliates who resell the oil arm's-length based on either index or the gross proceeds under the arm's-length resale contract. Lessee made election for 2-year period.	Sales to affiliates who resell the oil arm's length must be based on gross proceeds under the arm's-length resale contract. No election.
Sales to affiliates who refine the oil based on index.	Sales to affiliates who refine the oil based on index, except separate benchmarks established for Rocky Mountains.
Index prices based on: - NYMEX for all oil outside California/Alaska - ANS spot price for federal oil produced in California and Alaska	Index prices (except Rocky Mountains) based on: - St. James and Empire, Louisiana spot price for OCS Gulf production - Midland, Texas, spot price for West Texas/New Mexico federal oil - ANS spot price for federal oil produced in California and Alaska
Index prices published for deliveries in month <u>following</u> production month	Index prices published for deliveries <u>during</u> the production month
	Separate valuation procedures for Rocky Mountain Area (CO, ND, SD, MT, WY, & UT): Tendering Other purchases/sales in field or area NYMEX-based price MMS-approved alternative method
Royalty-in-Kind (RIK) values tied to NYMEX	Removed RIK valuation from the proposal

ADJUSTMENTS:

January and July 1997 Proposals	February 1998
Form MMS-4415 requested information on all oil exchanges in U.S. involving Federal Lessees.	Simplified Form MMS-4415 requires:
	Information only on exchanges involving federal oil production
	Information only on exchanges between aggregation points and market centers
–	Less data elements than earlier form
315 MMS identified aggregation points	217 MMS identified aggregation points
Quality/value differences reflected only in location differentials between market center and aggregation point	Separate quality/value adjustments permitted based on quality bank differentials, generally between aggregation point and lease
No specific provision for transportation allowances beyond lease if production sold at lease and index pricing applies	MMS would determine appropriate allowance for transportation from lease to aggregation point if production sold at lease and index pricing applies

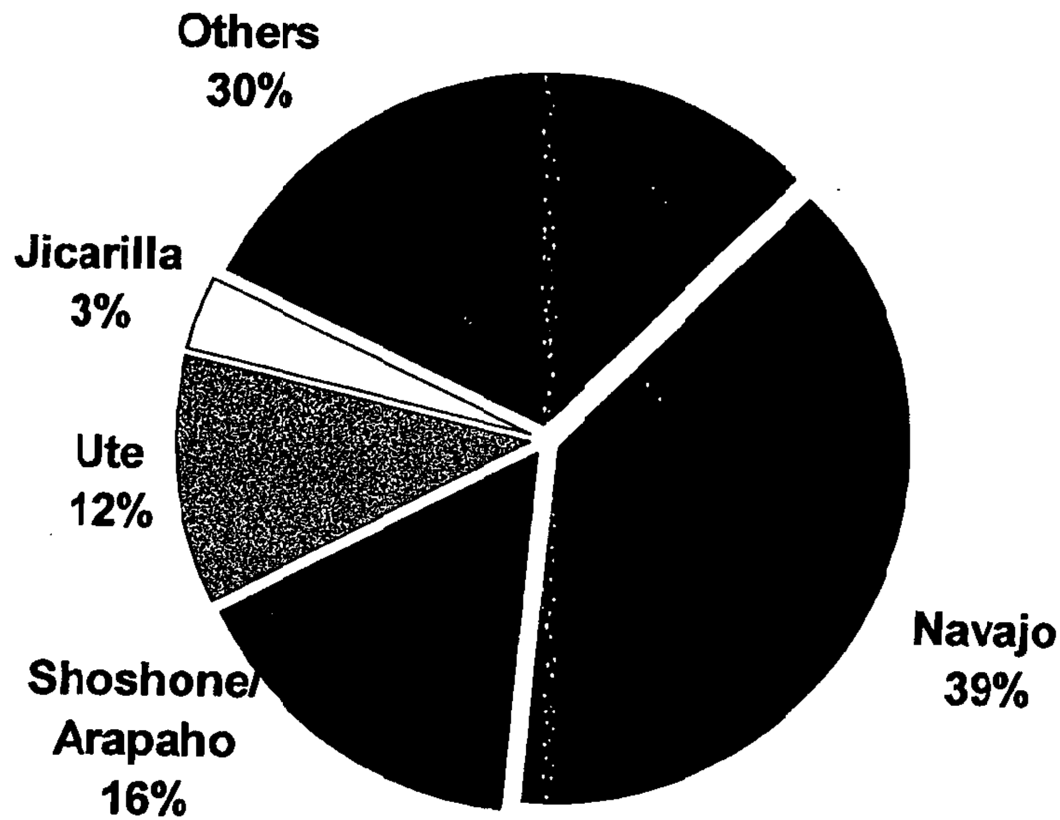
Comparison of Federal and Indian Oil Valuation Rules

The proposed Indian rule is different in several respects from the Federal oil valuation rule proposed on January 24, 1997, revised in a supplementary proposed rulemaking on July 3, 1997, and revised again in the February 6, 1998 supplementary proposed rule. These differences stem from unique Indian oil and gas lease terms, of which the major portion provision is the driving factor.

The important differences between the proposed Indian oil valuation rule and the supplementary proposed Federal rule are:

	Indian Rule	Federal Rule
Gross Proceeds	One component of three-value comparison together with NYMEX and major portion; higher of three is value	Would determine royalty value if true arm's-length sale
Valuation for Transactions Not at Arm's-Length	Comparison of gross proceeds, NYMEX, and major portion value; higher of three is value	Different criteria depending on geographic area; location and quality-adjusted spot prices for most production
Valuation Regions	One--Nationwide	Three-California/Alaska, Rocky Mountains, and rest of country
New Form Filing Requirements	Proposed new Form MMS-4416 would require detailed location differential, quality, transportation, and price information	Proposed new Form MMS-4415 would require less-detailed location differential, quality, and transportation information
Starting Point for Location Differentials and Transportation Allowances	Designated Area--generally the reservation boundary	The lease
Reporting Procedures	Initially report higher of Gross Proceeds or NYMEX; adjust later if MMS-calculated major portion value higher	Report value under appropriate valuation criterion; later adjustments only to correct errors or as MMS requires

Indian Crude Oil Production by Tribe



Attachment C

“MMS Proposes Further Amendments to Federal Crude Oil Valuation Rule,” MMS News Release, February 5, 1998.

MMS

U.S. Department of the Interior
Minerals Management Service
Office of Communications

NEWS RELEASE

FOR RELEASE: February 5, 1998

CONTACT: Michael L. Baugher (303) 231-3162
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MMS PROPOSES FURTHER AMENDMENTS TO FEDERAL CRUDE OIL VALUATION RULE

The U.S. Department of the Interior's Minerals Management Service (MMS) will publish in tomorrow's ***Federal Register*** a supplementary proposed rule that would amend the regulations establishing the value of oil from Federal leases.

In issuing the supplementary proposed rule, MMS Director Cynthia Quarterman said, "As a whole, this rule addresses the primary concerns of many of the oil and gas companies who have to calculate and pay royalty on crude oil produced from Federal leases. At the same time, it provides assurance to the Federal and State royalty recipients that value will be based on the best indicators of market value available for any given area of the country."

She further explained that, "It quite simply bases royalty value on the gross proceeds received when oil is sold under an arm's-length contract and on index pricing or other benchmarks in cases when oil is not sold under an arm's-length contract."

The proposed rule is the culmination of two earlier proposed rules, comments received, and several workshops held to gain input from constituents. In developing this proposed rule, MMS adhered to five basic principles of royalty valuation:

Royalty must be based on the value of production at the lease.

The rule provides for royalty payments based on no more than the value of production at the lease. Where index prices are used to establish value, actual transportation costs, location differentials, and quality adjustments would be applied in arriving at the value at the lease.

For arm's-length contracts, royalty obligations should be based on gross proceeds.

The MMS believes that gross proceeds received under the lessee's or its affiliate's arm's-length contracts remain the superior measure of market value, and clarifies this provision in the rule.

For other than arm's-length contracts, index prices are the best measure of value in most areas of the country.

MMS believes that index prices are the best indicator of the lease value for oil not sold at arm's length in areas other than the Rocky Mountains. For all areas of the country except the Rocky Mountains, MMS is proposing the use of spot prices, adjusted for quality and location. MMS has retained its previous proposal to use Alaska North Slope spot prices for production from California and Alaska. While comparisons show that spot and NYMEX adjusted values are essentially the same, spot prices have the added benefit of being established closer to the lease, thereby eliminating one step in calculating the differential. Only in the Rocky Mountain Area where the production is remote from major market centers and the spot market is thinly traded is MMS proposing a series of benchmarks, including NYMEX, for valuing production not sold at arm's length.

The lessee has a duty to market at no cost to the lessor.

Federal lease terms require the lessee to market production at no cost to the lessor. MMS has been consistently upheld on the position that such costs do not result in a value greater than the value of production. The proposed rule is consistent with that position.

Customized regulations for unique producing areas are preferable to a "one size fits all" approach.

Because California and Alaska and the Rocky Mountain Area exhibit particular oil marketing characteristics, MMS does not believe in a single regulatory approach. The proposed rule recognizes the geographic differences in the marketplace and proposes different royalty valuation standards for three distinct parts of the country.

Other news on the Federal oil rule.

- Economic analyses of the rule's effects show that about two-thirds of production in the Gulf of Mexico, which accounts for the largest share (76.7%) of Federal oil production, would be subject to index pricing.
- In the Rocky Mountain Area , where only 8.5% of the Federal oil is produced, value for about two-thirds of production would remain on gross proceeds.
- In California and Alaska, which account for 14.8% of Federal oil production, MMS believes that index-based valuation would apply to about three-quarters of the production.
- Overall, about one-third of Federal production nationwide is sold arm's length; the other two-thirds of the production would be valued using index prices or benchmarks.
- Form MMS-4415 would be greatly simplified with clearer instructions, fewer respondents, and fewer locations for reporting oil aggregation. Using spot prices rather than NYMEX for most areas of the country would also remove one of the adjustments to the index price.
- The comment period closes on March 23, 1998 . You may send comments to: David S. Guzy, Chief, Rules and Publications Staff, Royalty Management Program, Minerals Management Service, P.O. Box 25165, MS 3021, Denver, Colorado 80225-0165; or E-mail David.Guzy@mms.gov.
- MMS is planning to hold hearings to obtain public input on the proposed changes in this rule.

MMS will publish announcement of those sessions in the Federal Register.

MMS is the federal agency that manages the Nation's natural gas, oil, and other mineral resources on the Outer Continental Shelf, and collects, accounts for and disburses about $4 billion in revenues each year from federal offshore mineral leases and from onshore mineral lease on federal and Indian lands.

Editor's note: The ***Federal Register*** Notice can be found on the MMS website under the "What's New" heading.

Attachment D

"Analysis of the Department of Interior, Minerals Management Service's Request for Extension of the Existing Collection Authority for Form MMS-2014," Barents Group, March 6, 1998.

ANALYSIS OF THE DEPARTMENT OF INTERIOR, MINERALS MANAGEMENT SERVICE'S REQUEST FOR EXTENSION OF THE EXISTING COLLECTION AUTHORITY FOR FORM MMS-2014

PREPARED BY

BARENTS GROUP • LLC

A KPMG Company
2001 M Street, N.W.
Washington, DC 20036
202-467-3828

March 6, 1998

PREFACE

Barents Group LLC, a wholly owned subsidiary of KPMG Peat Marwick LLP, was retained by Gardere & Wynne LLP on behalf of a group of companies having significant crude oil and gas production on Federal lands to assist in analyzing the Department of Interior, Minerals Management Service's (MMS) request for an extension of the existing information collection authority for Form MMS-2014 (63 F.R. 252, published January 5, 1998). These companies are interested in and affected by the MMS request.

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EXECUTIVE SUMMARY

Barents Group LLC has been asked to analyze the Department of Interior, Minerals Management Service's (MMS) request for a three year extension of the currently approved information collection, Form MMS-2014. These companies are interested in and affected by the MMS request for an extension of the information collection.

Form MMS-2014 is used for reporting royalties and other lease-related transactions to MMS, and the current authorization expires on May 31, 1998. Approximately 274,000 lines are submitted each month on Form MMS-2014, and in its Federal Register notice, MMS estimates that the annual burden imposed by this information collection is 155,400 hours.

Our analysis indicates that MMS' estimate of the burden imposed by this information collection is mathematically incorrect. Using MMS' published data, we calculate that the compliance burden will be 238,600 hours annually — 54 percent higher than reported by MMS. MMS should review these calculations and make any appropriate corrections before proceeding.

On February 6, 1998, MMS published a further supplementary proposed rule which would substantially change the way crude oils value is calculated for Federal royalty purposes. Our preliminary analysis indicates that the proposed rule in its current form would significantly increase the time required to complete Form MMS-2014. MMS has failed to consider the impact that the proposed oil valuation rule will have on its currently approved information collections, and the impact should be considered and analyzed before the Form MMS-2014 or any other affected form is reauthorized for an extended period.

Form MMS-2014 is already the most burdensome of the currently approved MMS information collections. The proposed rule, in addition to imposing a significant new information collection, will further increase the burden required to complete Form MMS-2014. MMS should reestimate its estimate of the burden of this form and consider the impact the proposed oil valuation rule will have on the time required to complete the form before proceeding with the reauthorization request.

In sum, MMS should first correct its mathematical errors, publish a revised burden estimate if it is significantly higher, and then analyze the impact of the proposed oil valuation rule on the burden imposed by Form MMS-2014 before the information collection is reauthorized for the full three years requested. Because the oil valuation rule continues to be under consideration, MMS should request and OMB should authorize a one year extension of the existing information collection authority.

1. INTRODUCTION

The current Office of Management and Budget (OMB) control number for Form MMS-2014, Report of Sales and Royalty Remittance, expires on May 31, 1998, and MMS is requesting OMB approval for a three year extension of the existing information collection authority. Form MMS-2014 is the only document used for reporting royalties and other lease-related transactions to MMS, and the Auditing and Financial System (AFS) relies on these data to account for royalties collected from Federal and Indian leases. AFS also uses Form MMS-2014 data to perform monthly distributions of mineral revenues to State, Indian, and General Treasury accounts; to provide royalty accounting and statistical information to States, Indians, and others; and to identify under reporting and nonreporting. AFS information is compared with production data collected by an MMS automated production accounting system to verify that the proper royalties are being collected.

In its notice of agency information collection activities, MMS states that approximately 274,000 lines are submitted each month on Form MMS-2014 by about 2,000 payors. MMS estimates that it will take, on average, 7 minutes to manually complete each line, and this estimate includes time for data assembly, value and royalty calculations, entering data on the form, and mailing. For those companies who report using electronic media, MMS estimates that the time required to generate and submit the data is less than 3 minutes per line. In addition, MMS estimates that each payor will spend 10 hours on related recordkeeping for this information collection.

These estimates of the paperwork and recordkeeping burden of completing Form MMS-2014 are based on an analysis of the burden under current regulations. If the oil valuation regulations that MMS is currently proposing become final, the currently estimated burden of completing Form MMS-2014 is likely to be significantly understated.

This report first briefly summarizes the current and proposed oil valuation regulations (Section 2). Section 3 discusses internal inconsistencies in MMS' estimate of the annual burden. Section 4 discusses how the proposed changes in valuation methodology would affect the time required to complete Form MMS-2014. Finally, Section 5 presents our conclusions.

Because of the complexity of this issue, our analysis of the impact of the further supplementary proposed rule on Form MMS-2014 is preliminary.

2. MMS' BURDEN ESTIMATE IS INTERNALLY INCONSISTENT

As described above, MMS states that the total annual burden of the information collection is 155,400 hours. MMS also describes the time involved to gather data, calculate value and royalty, and complete Form MMS-2014. We have been unable to duplicate MMS' annual burden estimate using the information it provided. The following table shows MMS' assumptions.[1]

Table 1
MMS' Assumptions

	Number of lines (per month)	Time required (minutes)	Recordkeeping time
Filed electronically	208,000	3	10
Filed manually	67,000	7	10
Total	274,000[a]	n.a.	n.a.

[a] Note that 208,000 and 67,000 sum to 275,000, but MMS states that the total number of lines filed was 274,000 and shows the above breakdown. We assume this difference is due to rounding.

Using the information on the time required to complete Form MMS-2014 that MMS has provided we arrive at a very different burden estimate. Table 2 shows the steps involved in using this information to estimate total burden.

Table 2
Calculation of Burden Using MMS' Assumptions

	Lines per month	Minutes Per line	Total time (minutes/ month)[a]	Total time (hours/ month)[b]	Total time (hours/year)[c]
Filed electronically	208,000	3	624,000	10,400	124,800
Filed manually	67,000	7	469,000	7,817	93,800
Recordkeeping					20,000[d]
Total burden					238,600
MMS' estimate					155,400
Difference					83,200

[a] Lines per month multiplied by minutes per line
[b] Minutes per month divided by 60 minutes
[c] Hours per month multiplied by 12 months
[d] 10 hours multiplied by 2,000 payors

Table 2 clearly shows that one cannot duplicate MMS' estimate of 155,400 hours per month using the information it has provided — 54 percent higher than MMS' calculations. Indeed, to

[1] 63 FR 253

match the number which MMS claims to be the annual burden, we have to assume only one minute per line for the lines filed electronically, and such an assumption is unlikely to be reasonable. Indeed, if one checks OMB's inventory of active information collections approved under the Paperwork Reduction Act for Form MMS-2014 for the month ending June 30, 1997, the annual hours listed is 240,600, a figure similar to the one we have calculated above.

In addition, it is unclear from MMS' Federal Register Notice if the 10 hours of recordkeeping time MMS anticipates is a monthly or an annual estimate. We have assumed in our calculations that MMS considers this to be an annual amount, although this averages less than 1 hour per month and seems a very low estimate for recordkeeping required by payors in order to complete Form MMS-2014. If indeed MMS intended the 10 hour estimate to be a monthly figure, the total burden would increase to 458,600 hours, or 195 percent higher than the amount reported.

3. OVERVIEW OF CURRENT REGULATIONS AND PROPOSED RULE

The valuation of crude oil for royalty purposes is currently governed by a 1988 rule.[2] MMS believes that the methods described in the 1988 regulations are no longer appropriate. Since January 1997, MMS has published a proposed rule and two supplementary proposed rules that would substantially alter how royalties are calculated for crude oil produced on Federal lands and would thus affect the time required to complete Form MMS-2014. This section first describes valuation under the 1988 regulations and then describes valuation under MMS' current further supplementary proposed rule.[3]

CURRENT RULE

Under the 1988 rule, the valuation methodology is based on the concept of "gross proceeds" accruing to the lessee. Simply stated, the lessee pays the Federal government a royalty based on the price received for the oil at or near the well. The rule divides sales transactions into two groups: arm's-length contracts and non-arm's-length contracts. Under arm's-length contracts, the royalty value is established based on the gross proceeds accruing to the lessee; the gross proceeds concept reflects the consideration received by the Federal lessee from selling the oil.

If the oil is transferred in a non-arm's-length disposition to a "marketing affiliate," a defined term meaning an affiliate of the lessee which purchases only production from the lessee, the royalty value is established as the gross proceeds received by the lessee's affiliate in its first arm's-length sale.

If the oil is not sold under an arm's-length contract, then gross proceeds from the sale of the oil are calculated using the first applicable of the following five benchmarks:

1. the lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of like-quality oil in the same field, provided these are comparable to other posted prices or sales contract prices;
2. the arithmetic average of contemporaneous posted prices used in arm's-length transactions by persons other than the lessee for purchases or sales of significant quantities of like-quality oil in the same field;
3. the arithmetic average of contemporaneous posted prices used in arm's-length transactions by persons other than the lessee for purchases or sales of significant quantities of like-quality oil in the same area or nearby area;
4. prices received for arm's-length spot sales of significant quantities of like-quality oil from the same field (or same area) with adjustments for other matters unique to the circumstances of the lease or salability of the oil; or
5. a net-back method or any other reasonable method.

[2] 53 FR 1218-1222, January 15, 1988.
[3] 63 FR 6113, February 6, 1998.

In using any of the above methods for both arm's-length and non-arm's-length contracts, the lessee may deduct a transportation allowance equal to the "reasonable, actual costs" of transporting the oil (Section 206.104). In certain circumstances, the lessee may use Federal Energy Regulatory Commission ("FERC") or State tariffs instead of transportation costs calculated using an MMS methodology. Under no circumstances can the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production, less applicable deductions.

The new rule proposed by the Department of the Interior, Minerals Management Service specifies a very different approach for determining the value of oil for royalty purposes.

PROPOSED RULE

On February 6, 1998, MMS published a further supplementary proposed rule which requires the use of spot prices with certain adjustments for calculating value for royalty purposes for non-arm's-length transactions in most of the United States and divides the United States into three geographic regions, each with different methodologies.

Modifications in Reporting Requirements

The further supplementary proposed rule proposes a new form, Form MMS-4415, which would be filed for all the lessee's and their affiliates' crude oil production from Federal leases that is exchanged under arm's-length exchange agreements between paired aggregation points and market centers. The form requests the following information: lessee name and address; lessee payor code; reporting period; contract party name; exchange party payor, if available; contract type and contract number; the effective date, initial term, and expiration terms of the contract; the aggregation point and market center; the volume of oil transferred or received; the exchange differential received or paid; and certain quality information and adjustments including API gravity (either deemed or actual), the gravity adjustment received or paid, the actual or deemed sulfur content, the sulfur adjustment received or paid, and any other quality adjustment and the amount received or paid.

Modifications in Valuation Methodology

Under the further supplementary proposed rule, the value of crude oil for royalty purposes is the gross proceeds accruing to the seller less applicable allowances.[4] This also applies if oil is transferred under multiple non-arm's-length contracts and ultimately sold at arm's length, regardless of the number of non-arm's-length transfers before the final sale. This requires that lessees trace all transfers until the point of ultimate, arm's-length sale, including any and all location and/or quality differentials. The following adjustments are allowed for arm's-length sales:

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[4] Gross proceeds is a defined term under the proposed rule, and the definition differs from the definition of gross proceeds under the current rule.

- A location/quality differential determined from an arm's-length exchange agreement reflecting the difference in value between an aggregation point and a market center or between a lease and a market center;
- Actual transportation costs between an aggregation point and a lease; and
- Quality adjustments based on premia or penalties determined by pipeline quality bank specifications at intermediate commingling points, at the aggregation point, or at the market center that applies to the lease.

There are four exceptions to gross proceeds rule, and these include:

1. MMS may require you to value oil as non-arm's length, if MMS determines that an arm's-length contract does not reflect the total consideration actually transferred;
2. You must value oil as non-arm's-length if MMS determines that gross proceeds does not reflect a reasonable value because of misconduct by either party to the arm's-length contract or a breach of the duty to market the oil to the mutual benefit of the lessee and lessor;
3. Oil is disposed of under a non-arm's-length exchange; or
4. Oil is subject to a noncompetitive crude oil call.

Oil falling under these exceptions would have to be valued using the methodology for non-arm's-length transactions. These exceptions can generally only be verified through audit.

The non-arm's-length methodology is now broken down into three regional schemes. For production in California and Alaska, the value of crude oil would be the average daily mean Alaska North Slope (ANS) spot prices adjusted for applicable location and quality differentials and possibly for transportation costs.

In the Rocky Mountain Area, crude oil would be valued using a system of four benchmarks :

1. Values established by an MMS-approved tendering program;
2. The volume-weighted average gross proceeds received;
3. The average of daily NYMEX futures prices adjusted for applicable location and quality differentials and possibly for transportation; or
4. An alternative established by the MMS Director.

The rest of the country would use average daily mean spot prices for the market center nearest the lease where spot prices are published in an MMS-approved publication. This spot price must then be adjusted for location and quality differentials and possibly for transportation costs. MMS is not proposing to allow the costs of marketing production to be deducted.

The following deductions would be allowed for oil valued using these non-arm's-length methodologies:

- ♦ If production moved directly to alternate disposal point:
  - ◊ Actual transportation costs between the aggregation point and the lease (Treat alternate disposal point as aggregation point);[5]
  - ◊ Quality adjustments based on premia or penalties determined by pipeline quality bank specifications at intermediate commingling points, at the aggregation point, or at the market center that applies to your lease.[6]
- ♦ If production moved directly to an MMS-identified market center:
  - ◊ Actual transportation costs between the market center and the lease;[7]
  - ◊ Quality adjustments based on premia or penalties determined by pipeline quality bank specifications at intermediate commingling points, at the aggregation point, or at the market center that applies to your lease.[8]
- ♦ If production neither moved to an alternate disposal point or to a market center:
  - ◊ An MMS-specified location/quality differential determined from arm's-length exchange agreement that reflects the difference in value of crude oil between the aggregation point and the market center;[9]
  - ◊ MMS will publish annually a series of differentials applicable to various aggregation points and market centers based on data collected on Form MMS-4415. MMS will calculate each differential using a volume-weighted average of differentials reported for similar quality crudes for the aggregation point market center pair for the last year. Use these differentials to report the value of production during the calendar year.[10]
  - ◊ Actual transportation costs between the aggregation point and the lease (Treat alternate disposal point as aggregation point);[11]
  - ◊ Quality adjustments based on premia or penalties determined by pipeline quality bank specifications at intermediate commingling points, at the aggregation point, or at the market center that applies to your lease.[12]

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[5] Proposed Section 206.112(c)
[6] Proposed Section 206.112(e)
[7] Proposed Section 206.112(d)
[8] Proposed Section 206.112(e)
[9] Proposed Section 206.112(b)(1)
[10] Proposed Sections 206.112(b)(2) and (3)
[11] Proposed Section 206.112(c)
[12] Proposed Section 206.112(e)

4. IMPACT ON FORM MMS-2014

The further supplementary proposed rule clearly represents a significant departure from current practices, and as such, the impact the proposed rule would have (assuming the rule becomes final) on completing Form MMS-2014 should be carefully considered and analyzed. In its request for a three-year extension, MMS does not consider and indeed does not even mention the potential impact of the proposed rule on the recordkeeping and reporting burden of Form MMS-2014. This section presents some preliminary analysis of how Form MMS-2014 would be affected by the proposed rule.

The further supplementary proposed rule will substantially increase the time and recordkeeping required to complete Form MMS-2014. As described in the previous section, the proposed valuation methodology is very different from the current methodology and for many payors will be far more burdensome. MMS estimates that it currently requires seven minutes on average to manually complete each line, and this includes time for data assembly, value and royalty calculations, entering data on the form, and mailing. As discussed below, if the further supplementary rule becomes final, this estimate is no longer valid.

Consider the case of crude oil that is transferred in two non-arm's-length transactions before being disposed of in an arm's-length sale. As described above, oil disposed of in this manner must be valued using the proposed gross proceeds method as the ultimate sale is at arm's length. Under the further supplementary proposed rule, the person completing Form MMS-2014 would be required to obtain the sales price from the party that sold the oil at arm's length. Assuming that person was able to obtain the sales price from the ultimate seller (and this is something that is by no means certain), it must then trace through each transaction from arm's-length sale to the first non-arm's-length transfer keeping track of any appropriate location and quality differentials and actual transportation costs. Because the crude oil may have been commingled with other production form wither Federal or non-Federal leases, wither direct tracing or, more likely, some allocation method will be required. This alone will likely take far in excess of seven minutes, and this does not allow any time for calculating value or royalties or completing the form.

For production from Federal leases in Alaska and California, the lessee must start with the average of the daily mean ANS spot price for the calendar month preceding the production month. This average daily mean is not published, and so the lessee must first obtain the data and then calculate the average daily mean for the appropriate month. The ANS spot price must then be adjusted for location and quality differentials. The allowable differentials vary depending on the disposal point and require the lessee to select from a "menu of options." The following text from the supplementary proposed rule illustrates the complexity of this proposed methodology.

> *(a) If you dispose of your production under an arm's-length exchange agreement, use Sec. 206.112 (a), (c), and (e) to determine your adjustments and transportation allowances. For non-arm's-length exchange agreements, use paragraph (d) of this section.*
> *(b) If you move lease production directly to an alternate disposal point (for example, your refinery), use Sec. 206.112 (c) and (e) to determine your actual*

costs of transportation and to adjust for quality. Treat the alternate disposal point as the aggregation point to apply Sec. 206.112(c).

(c) If you move your oil directly to a MMS-identified market center, use Sec. 206.112 (d) and (e) to determine your actual costs of transportation and to adjust for quality.

(d)(1) If you cannot use paragraph (a), (b), or (c) of this section, use Sec. 206.112 (b), (c), and (e) to determine your location/quality adjustments and transportation allowances, except as provided in paragraph (d)(2) of this section.

(2) If you dispose of your production at the lease in the exercise of a non-competitive crude oil call, and if you cannot obtain information regarding the actual costs of transporting oil from the lease to the aggregation point, or pipeline quality bank specifications necessary to apply Sec. 206.112 (c) and (e), you must request approval from MMS for any transportation allowance.[13]

The lessee must select the appropriate adjustments as described above and be able to demonstrate to MMS which adjustments were used. The methodology is similar for the rest of the country, excluding the Rocky Mountain area, but rather than using the ANS spot price, the lessee must begin with the published spot price for the market center closest to the lease.

For production in the Rocky Mountain area, the lessee must start with a price derived from either it MMS-approved tendering program, a volume-weighted average price of its and its affiliates arm's-length sales and purchases, or the NYMEX price. It is unclear whether any adjustments would be allowed if using either of the first two benchmarks, and for the third benchmark, NYMEX price, the price should be adjusted using the allowable adjustments described in proposed 206.113. If none of these result in reasonable values, the lessee may request an alternative from the MMS Director.

The further supplementary proposed rule, like current regulations, requires that transportation costs be reported on a separate line. The supplementary proposed rule, however, changes the way transportation costs must be calculated. It eliminates the lessee's ability under current rules to apply for the use of affiliates' Federal Energy Regulatory Commission (FERC) and State-approved tariffs when computing Federal royalties. Rather, affiliated lessees are required to use actual costs. For affiliated payors, these calculations will substantial require additional time and will significantly increase the recordkeeping burden required to complete Form MMS-2014. The further supplementary proposed rule is also unclear as to how allowances are to be reported. Specifically, it provides no guidance on how location and quality differentials are to be reported, nor does it address the issue of how a transportation allowance would be reported for an affiliated arm's-length transaction.

Form MMS-2014 generally assumes that there will be one type of disposition and valuation methodology used for any one lease; that is, production will be sold in one way. It is not unusual, however, for production from a lease to be disposed of in more than one way. For example, a lessee may ultimately sell some production at arm's-length and transfer the remaining production from that lease to its refinery. Under this scenario, a lessee would be required to value the production from that lease in two ways: using the proposed gross proceeds

[13] Proposed 206.113 63 FR 6131

methodology and using an index methodology. This would require that the values for the arm's-length transaction and the non-arm's-length transaction be reported on two separate lines of Form MMS-2014.

It is also conceivable that production from the Rocky Mountain Area and production from New Mexico or even California could be commingled before disposition. As described above, that commingled production could be disposed of in more than one way. Following this example, the production would have to be valued in several ways under the further supplementary proposed rule. The production ultimately disposed of at arm's-length would be valued using the proposed gross proceeds methodology, and all transactions related to this production would have to be traced back to each lease. For the production disposed of in a non-arm's-length transaction, the lessee would be required to value that production using not one, but two non-arm's-length methods: one for the Rocky Mountain Area and one for New Mexico or California. This could also potentially require that four sets of adjustments and transportation allowances be calculated. For such a set of transactions, the lessee would be required to report the values on several lines of Form MMS-2014.

Given that Form MMS-2014 generally contemplates one disposition or accounting from one lease, the further supplementary proposed rule has the potential to significantly increase the number of lines reported annually.

Additionally, being required to value production disposed of under non-arm's-length contracts using three different methods would be likely to require three separate computer systems: one for each geographic area. Developing these systems would involve large start-up costs and regular maintenance costs. The computer systems currently being use to calculate value for Federal royalty purposes would become obsolete as the system would change so substantially. If the further supplementary rule becomes final, MMS must take this increased burden into account. Additionally, the further supplementary proposed rule may require changes in payor codes/AID number relationships to accommodate geographical pricing. Such reporting requirements may require that the systems used to complete Form MMS-2014 be reprogrammed.

The further supplementary proposed rule specifies a number of recordkeeping requirements necessary to show how the lessee or its affiliate calculated value for royalty purposes. This include:

- The lessee or its affiliate must be able to demonstrate that a contract or exchange agreement is an arm's-length contract or exchange agreement.[14] MMS may require the lessee to certify that arm's-length contract provisions include all of the consideration the buyer must pay, either directly or indirectly, for the oil.[15] MMS does not provide any guidance on how this is to be accomplished.
- Retain all data relevant to the determination of royalty value. The lessee must be able to chow how it calculated the value reported (on Form MMS-2014), including all adjustments

[14] Proposed 206.102(d)(1) 63 FR 6128
[15] Proposed 206.102(d)(1) 63 FR 6128

for location, quality, transportation, and how the lessee complied with there rules.[16] Indeed, in the preamble to the proposed rule, MMS states that if the lessee is unable to demonstrate on audit how it calculated the value reported to MMS, the lessee could be subject to sanctions for false reporting.[17]

- For arm's-length transportation contracts, the lessee or its affiliate must use a separate line entry on Form MMS-2014 to notify MMS of a transportation allowance. MMS may require a lessee or its affiliate to submit arm's-length transportation contracts, production agreements, operating agreements, and related documents.[18]
- For non-arm's-length transportation contracts, the lessee or its affiliate must use a separate line entry on Form MMS-2014 to notify MMS of a transportation allowance. For new transportation facilities or arrangements, initial deductions must be based on estimates of allowable transportation costs. MMS may require the lessee or its affiliate to submit all data used to calculate the allowance deduction.

Complying with each of these requirements will require substantial recordkeeping time, and MMS must consider the impact of the further supplementary proposed rule on this estimate of burden. As previously discussed, it is not clear whether MMS' 10 hour recordkeeping estimate is monthly or annual. Even assuming that it is intended to be monthly, it clearly does not anticipate the extensive burden required under the further supplementary rule.

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[16] Proposed 206.105 63 FR 6129
[17] Proposed 206.105 63 FR 6120
[18] Proposed 206.116 63 FR 6131

5. CONCLUSION

MMS should neither request nor be granted a three year extension of the current information collection authority for Form MMS-2014. Rather, a one-year extension should be provided while the proposed oil valuation rule is under consideration. In the interim, MMS should be required to examine the impact that the proposed rule will have on the MMS-2014. Additionally, MMS must correctly estimate the burden of completing Form MMS-2014 under current regulations before proceeding.

Form MMS-2014 is already the most burdensome of the currently approved MMS information collections,[19] and the proposed rule, in addition to imposing a new information collection, will make completing Form MMS-2014 more burdensome.

[19] The OMB inventory of active information collections approved under the Paperwork Reduction Act presents estimates of annual burden hours for all approved information collections. According to that inventory, Form MMS-2014 has the highest annual estimate of all MMS' approved information collections.